OUR PRESENT FINANCIAL OUTLOOK

In December, 1890, the Baring's failure announced to the world that the credit institutions of Europe had called a halt. A period of promotion and speculation in new industrials, in railways, in the securities of South America, Australia and South Africa, was suddenly ended. The movement preceding the failure had been one of expansion—a struggle for increasing gains; the movement following was marked by credit retraction and trade depression—by efforts to recoup and prevent further loss. Although for two years after 1890 we had tremendous forces working in our favor (with unprecedented yield of grain and higher prices of food stuffs due to crop failure abroad), the detracting influences of foreign depression and foreign financial reorganization brought home to the United States the fact of over-speculation; in 1893 our credit institutions collapsed and we followed the wake of Europe through a period of depression.

Our experience of 1893, following 1890, was similar to our financial collapse in 1884, following foreign failures in 1881. 1903 brings us again to face the possibility of a similar repetition. About two years ago another period of foreign speculation abroad came to an abrupt end; since that time Germany and England have been passing through financial readjustment and reorganization. Here in the United States, as in the two years following 1890, we have had forces at work to keep the wheels of industry moving at an increasing rate. Trade journals have looked upon this growing activity as evidence of national superiority—an era of unprecedented prosperity based on safe business methods. *Dun's Review* in its leading January issue says "The new year opens with every prospect of exceptional activity in all branches of business." While those engaged in manufacture, in merchandising, and in transportation enterprise see nothing but increasing activity, while they were never more sanguine, the experience of the last four months of 1902 has caused those in financial circles to regard the situation with feelings of serious doubt. Months of strain on our commercial credit institutions, months of adverse gold movements, months of increased speculation have put those in control on their guard. The financial situation has been the general topic of deliberation among bankers

and these deliberations find strong expression in appeals to the national government for measures of relief.

Among those who have sounded notes of warning is the vice-president of the National City Bank of New York. Commenting on the financial outlook Mr. Vanderlip shows that the increase in activity of every kind has been accompanied by a like increase in the "credits of account" (or deposits) sold by banks to their customers; and that along with so-called prosperity have been purchases of commercial paper by the banks by means of these increased book credits or "deposits." The expansion in the credit funds of the national banks alone, since 1896, amounts to $1,600,000,000, while other institutions of deposit have increased their current funds offered to the public for use $2,300,000,000. This gives a total of $3,900,000,000—an increase in credit funds, within six years, amounting to almost double the entire money stock of the country, both in circulation and in the treasury.

But what has been the increase in banking equipment, the strengthening of the machinery of credit issue? What provision has been made by the banks for maintaining these increased burdens on the credit structure? After showing that during the last three years, since 1899, the credit accommodations of national banks have increased $1,300,000,000 Mr. Vanderlip further comments as follows: "With that increase in liabilities of national banks in mind, let us look at the figures representing the *reserve* basis. The total of specie and legal tender held by national banks last month was $508,000,000. The total at the beginning of 1899 was $509,000,000. Here we have had an expansion of $1,300,000,000 in deposits (demand obligations of the banks used in the community for funds), while the basis of gold and legal tenders, upon which that inverted pyramid stands, is actually slightly smaller than it was at the beginning of the period. Now in that same time, the deposits of the other banks—state banks, trust companies, savings banks and private banks—have probably increased not far from $3,000,000,000, and there is little likelihood that *their* gold and legal tender reserve is materially larger than—if it is as large as—at the beginning of 1899. We have had, then, in less than four years, an increase in the bank deposits of the country of over $4,000,000,000 accompanied by no increase in the specie or legal tender holdings of those banks." The data relied on for this conclusion are taken from

the last Report of the Comptroller—an official compilation made from the returns of the banks themselves. The evidence presented in this Report goes farther; it shows that during the period under discussion the capital of these institutions had not materially increased. March 6, 1893, the capital and surplus of national banks amounted to $934,000,000; whereas September 30, 1901, it was in millions exactly the same, though, as a matter of fact, it was a few thousand dollars less. Without therefore increasing the capital employed in the business, the banks have been offering to the public, and actually selling, about twice the amount of demand credit for use of the business community for funds as they had oustanding in 1895.

From this first array of facts Mr. Vanderlip proceeds to a second conclusion:

> "*What has brought about this remarkable development of bank credit?" he asks.* "The answer must at once come to the mind of any observer of finance, that the principal reason for the expansion of deposits and the accompanying expansion of loans (commercial paper held by banks), is to be found in the great movement which has been the significant feature in financial affairs of the last half-dozen years—the movement to *aggregate industrial establishments into single great corporate units and to convert the evidence of ownership into corporate securities which have entered actively into the stream of financial operations.* Vast amounts of new securities have been created in these half-dozen years, based in a large measure upon properties which were before held as fixed investments by individuals, or, if standing in the form of corporate property, the securities of these corporations were more closely held, and, in but small measure, entered into the financial operations of the day. This movement—tending to convert the evidences of ownership of a great amount of fixed property into a form which has been considered a bank collateral, and which has been made the basis of loans and of corresponding increases of deposits—is undoubtedly the most important single cause for the increase of more than $4,000,000,000 in bank deposits and bank loans of the country in the space of three or four years."

The basis for criticism of every "note of caution" addressed to the public is found in the exuberant feeling current, expressed in the oft-repeated phrase "national prosperity." The ancestral lineage of this prosperity is not hard to trace. Attention is called to the fact that the depression from 1893 to 1896 was a period of financial re-organization and of the introduction of economies in our enormous industrial establishment. The water had been gradually squeezed out of previously inflated capitalizations and the nation

during this period had come to rely for its "cash," as well as for its incomes on *profits* from legitimate business. With such an equipment we were able to sell pig-iron at a profit at $10.00 to $12.00 per ton. Steel rails were sold with a liberal return to capital at $17.50. Bar iron entered a profitable market at 95 cents per hundred. Thousands of other commodities were produced at a profit at prices such that they began to find their way into foreign ports and in competition with foreign made goods undersold them. Europe was shocked at our strength developed; our appearance with ship loads of goods that others could not manufacture at competitive rates, made the world realize that in the western continent were resources and an industrial development that in free competition might bid defiance to all Europe. Under such circumstances bills of exchange, representing these goods formed a true basis for commercial bank loans, and bank credits were supported by capital equipment adequate to protect them—an equipment that included a 33 per cent money reserve for the redemption of demand obligations. As our foreign trade increased, instead of allowing this banking equipment to become impaired, we at that time imported gold for new reserves, to support new credits; and new current funds were again at hand for the support of still larger commercial accommodations in the purchase of bills and commercial paper based on actual sales of produce.

What was the result, however, when the commercial bank extended its support to capital construction and became the chief factor in the new "industrial speculation" that grew out of this sudden national awakening? Instead of limiting the commercial banking business to the service of a commercial constituency, instead of devoting the energies and the funds of commercial banks to the accommodation of producers and merchants, they began a system of underwriting new flotations. This was not a new experience, however. This experience is recalled by reference to the "real estate" restriction on national banks. Back of the law forbidding national banks to loan on real estate securities may be seen the long periods of industrial depression and financial reorganization following the panics of 1825, 1837 and 1847. Each period of prosperity immediately preceding these crises had been a period of capitalization of new agricultural resources. A westward migration had appropriated for use large areas (a new empire) of grain lands for which

new transportation development had opened a market to the seaboard. New cotton, tobacco and hemp lands enlarged this area to an extent such that the resources appropriated and undeveloped were larger than the old Atlantic slope to which capital had before confined its investments. The demands of these new areas are summarized in a general clamor for new capital, and the commercial banks attempted to supply this demand. The failure of some eight or nine hundred commercial banking institutions after 1837 was the result of this kind of bank credit employment.

The failures of banks, through three decades of state banking on investment securities, brought to the mind of practical bankers, the character and purpose of the commercial bank. Organized and capitalized for the purpose of rendering service to a business community in furnishing "current funds" or "cash" for current use, the equipment of the commercial bank is necessarily ill adapted to the work of "permanent capitalization." To employ the funds of a commercial bank for long time investment was found unsafe, and legislation was invoked to protect the public against loss. To apply a short time credit institution to such work is like using a sewing machine for riveting boiler plates, or attempting to use a traveling crane for sugar tongs; it is the application of equipment to work for which it is not adapted, with the result that either the equipment itself is impaired or the service to which it is applied becomes a dangerous one. What is the normal course of events in the "permanent capitalization" of enterprise? No conclusion could be more sound than that suggested in Mr. Vanderlip's address. *Capital funds* are obtained for the purpose of procuring the permanent equipment of an enterprise. One wishing *capital funds* must ordinarily apply to someone having funds for long time investment. Capitalization depends on the long time investment powers of a community. Capitalization can safely increase only so fast as investment capital increases. Investment capital is increased by the net incomes of capitalists in the form of returns on prior investments or by profits. The demand credits (or deposits) of banks are neither of these, and therefore are not proper funds for use in purchasing permanent equipment.

In the present period of inflation it was not found necessary to await the tardy development of capital funds; promoters did not find it necessary to appeal to such an investing constituency. They

found that by incorporating industrial enterprises, and consolidating corporate control into still larger corporate syndicates, these new securities or "industrials" so created could be listed on the market and there be made the subject of general quotation. This step taken, the speculation induced by the sudden realization of our greatness as a world power was converted into an agency for marketing the new securities to banks. An active buying having been "stimulated," it was not necessary to wait for the investing public to absorb the flotation; the margin speculator was utilized to obtain capital funds from our commercial credit institutions, using the securities so created as "collaterals."

One syndicated issue having been introduced into the speculative pool and floated on margins, the promoters having realized, a new consolidation was undertaken and funds were procured from the commercial banks in like manner. The infection spread from industrials to railroads, to mines, to every form of undertaking. It was on this character of banking resources—loans, secured by newly-created collaterals—that a large part of the increase in our credit funds (the deposits of commercial banks) was based. It was the danger involved in such a system of financiering that Mr. James J. Hill might have had in mind in his speech before the Manufacturers' Association at Chicago when he called attention to the current method of creating corporations, "not for the purpose of manufacturing any particular commodity . . but for the purpose of selling printed sheaves of securities which represent nothing more than the good will and prospective profits of promoters."

That enormous increase in industrial activity has resulted, cannot be denied. The cause of this increased activity, however, is quite as apparent. The immense amount of new funds made available for "capitalization," through the flotation of securities, increased the demands for every kind of materials—of construction, of maintenance and of subsistence. The manufacturers of pig-iron could not fill domestic orders and prices advanced from "$12 per ton in October, 1898, to $25 at the beginning of 1900. Steel rails doubled in the same period, the price going from $17.50 to $35. Bar iron scored even a greater percentage of gain within a shorter time, the price advancing from 95 cents a hundred in July, 1897, to $2.60 in October, 1899. The quotations of clear pine boards advanced from $45 to $73 a thousand; for brick from $4.50 to $6;

rope from 5¼ cents to 13 cents; and salt from 21 cents to $1." Prices were advanced all along the line—in cases doubled and quadrupled. An increase of from four to six billions in the *credit funds*—billions, not millions—made available to the country as a means of purchasing new materials and new services by a simple process of "flotation" has put the conduct of enterprise into the hands of promoters who have little thought for the future. Of what interest is it to the promoter that he is offering prices for materials twice or three times their cost four or five years ago, when the funds with which to pay for them are so easily obtained? Why should he be concerned with *cost* when his profits are to come from promotion and equipment instead of coming from permanent income on investment?

These new trade demands, based on credit funds obtained from speculative flotations, have increased the profits of enterprise enormously and the new margins of profit have carried speculation to a still higher mark; again new market quotations are made a basis for estimates of valuation of securities offered for collaterals, increasing the bank credit made available for higher spendthrift prices; these again return larger immediate earnings to plants set in motion at a higher speed with larger equipment for supplying demands. Long since has the foreign market been abandoned in many lines, while foreign manufacturers are shipping goods to the United States, finding a wide margin of profit in prices here after paying a tariff of from 40 to 60 per cent. No other explanation is needed for the reverse of the foreign trade balance. Instead of having a trade balance to be settled by Europe, this has been so far reduced that we are now borrowing largely from them in the form of "finance bills," a newly created form of floating debt incurred by our bankers as a means of meeting the demands of a commercial constituency. Instead of importing gold, since 1898, "there has, in spite of the theoretical trade balance, been no significant shipment of gold in our direction." More than this, our financial institutions have not the strength to keep gold on this side. Since that time we have lost about $100,000,000. Conservative bankers pertinently ask "What of the future?" "If a hundred million dollar importation of gold can serve as a basis for an expansion of so many millions of dollars of deposits and loans, what will an exportation of $100,000,000 mean?" It might be added that it

would, in all probability, have resulted in a complete overthrow of the so-called prosperity had not the commercial banking institutions been able to bring to their relief the United States Treasury with deposits of about $150,000,000.

But even with the support given by the treasury, the credit problem was not yet solved. The question of the ability of the commercial banks of the country to serve their commercial constituency with current credit funds—of adjusting the speculative situation and forcing liquidation of speculative loans to such an extent as not to compel them to restrict accommodations to commercial business—has kept the New York banker in a quandary by day and has hung over him like a spectre by night for the last three months. With all effort bent toward the common cause, with united action on the part of the commercial banking fraternity, acting on the best counsel, and combining their united resources with those furnished to the banks by the Treasury, they were unable to maintain their banking equipment intact. To a large extent the "capitalization" of these new promotions has fallen on them, and weakened their equipment for the support of current credit funds. "In 1899, the national banks held 33 per cent of reserve . . . . the last report shows less than 21 per cent of reserve for all the national banks of the country. Not one of the three central reserve cities was up to the legal limit. Twenty-two of the thirty-three reserve cities were below the legal limit."[1]

During the first weeks in January there was a relaxation of nervous tension. Those whose mental vision has not extended beyond a narrow constituency—those who have shown themselves incapable of grasping the broad situation—are again exchanging congratulatory messages. Others, however, with a broader view and bearing are less sanguine. Even at a time when bankers are breathing freely, and when new plans are again being made for taking on new collateral loans by way of aid to new syndicated issues, a leading conservative financial daily asks New York to stop and consider.

"It is a matter of common knowledge," says the *Wall Street Journal*,[2] "that this country is indebted abroad on what *might* be current account to a considerable extent. This indebtedness consists in the main of borrowing on bankers'

[1] Mr. Vanderlip's speech before the North Eastern Bankers' Association.
[2] Editorial on "The Financial Outlook," January 17, 1902.

bills of exchange, otherwise known as finance bills, and direct borrowings on collateral from the London banks. Not very much has been heard of the latter borrowings, but trustworthy authority states that they are quite considerable. They represent speculative holdings of stocks carried in London, where it has been cheaper for some months to carry such stocks than it was here. We are now entering upon the first period of what may be called relatively easy money in some months, and it is a matter of decided interest to know to what extent this ease will be availed of to reduce foreign indebtedness."

"The problem, of course, consists in the main of providing exchange to the amount desired. This can be done in three ways. It can be done (1) by the shipment of produce, (2) by the shipment of securities, and (3) by the shipment of gold . . . It is a gratifying thing to have exports of corn and other merchandise increasing at this time. It may well be doubted, however, that the increase is anything like large enough to take care of the present position without assistance from one or other of the remaining two sources of exchange. Considering the question of export of securities, it is doubtful if much can be looked for in this direction. Foreign investors naturally regard prices of our stocks as pretty high, and besides, some important new loans will shortly be offered in London and elsewhere to an amount quite sufficient to absorb the spare cash of the investor. Borrowings in connection with the Transvaal alone will, it is believed, amount to $350,000,000 in London this spring. So far as can be seen there is no reasonable prospect of much export of securities in the next few months."

"The export of gold to a moderate extent would seem to be the natural expedient in the circumstances. This is the season of the year when gold usually goes out, and, with money easy here, there is nothing to prevent it. Failing, strong efforts on the part of financial interests to extend their borrowings for another period, it is reasonable to assume that a round amount of gold will be exported between now and the end of June. Some exchange authorities think that from $30,000,000 to $40,000,000 will go within that time.

"Now, assuming that such is the case, the question of the money supply for next summer and fall becomes of great interest. . . . The sum and substance of the matter is that unless there is currency legislation of some kind, leading to inflation of the circulating medium, the chances are that the coming summer and fall will witness a tighter money market than was seen last summer and fall."

In another quarter the question is raised as to whether the banks will avail themselves of the present improved condition of the market to reduce the amount borrowed from the government. This measure seems necessary as a means of strengthening the possibility of again obtaining aid when support may be needed. To encourage such return on the part of the banks the secretary has issued a notice that all "securities," other than United States bonds, which have been placed as collateral to government deposits must be withdrawn

and government bonds substituted before August 1. This circular has caused consternation. Some bankers have expressed the opinion that such measure would be impossible without causing serious disturbances, either from the restriction of commercial loans or from the restriction of the bank note circulation.

With such a situation before us may not the Ex-Assistant Treasurer's negative but suggestive conclusion still be held before the financial world with profit: "The evidences then of advancing prices, that check exportation and increase importation, the absorption of our favorable trade balance in foreign investment and in the purchase of securities, the uncertain totals of our floating indebtedness represented by short time finance bills, all taken in connection with the fact that any reduction of the specie reserve held by banks must be followed by liquidation which will again establish the proper relation between reserve and deposit liability, would seem at least to point to the conclusion that this is not a time favorable to the expansion of bank credits."

The most significant fact concerning this warning is that, at present, it is not heeded. With easier monetary conditions the banks are not utilizing the opportunity for renovation of accounts—for unloading the form of investment that constitutes an element of danger, they are not returning to the strict lines of a commercial banking business—one in which their funds and capital equipment is shaped for commercial accommodation; on the other hand they are again increasing accommodations to speculators and becoming involved in the same sort of indirect "capital loans" as before. The question that is now being asked by some conservative thinkers seems pertinent, therefore, whether or not as a practical problem, considering the enormous holdings of stocks and collaterals, the commercial banks *will* get over to a conservative banking business—a business limited to the service of a constituency having need for "current funds" for industrial and commercial purposes,—and whether they *can do so* without overthrowing the whole financial system built up on the folly of allowing their "current credits" to be used for capital equipment.

This problem must rest for its solution in two financial factors: (1) the demands that may be made for payment of the floating debt of the banks, (2) the investment capital that will come to their relief by absorbing the securities created. If in their return to con-

servatism the current demands from floating debt do not exceed the new supply of investment capital that comes into the market for the securities held, the dangers arising from speculative employment of bank capital may be passed without seriously hampering the commercial demand for current funds. In the effort to find such an investment constituency the situation becomes still further involved. Recognizing the advantage of having within reach a clientele strong enough to absorb the flotations that incumber the transactions of commercial institutions, a plan of institutional support is at present being incorporated into the general financial web—a movement to consolidate investment companies in such a manner as to bring them under the sway of promoting interests. This movement finds its best illustration in the consolidation of old-line insurance companies, savings banks and trust companies, and through alliance with previously consolidated commercial banks, by the intermediary of a holding company, to reduce them to common management and control.

While by such a method an investment constituency for the time being is secured for such flotations as are now taken and held as collaterals by the commercial banking institutions, the movement is fraught with dangers—dangers even greater than the former expedients employed and to which reference has already been made. By bringing insurance, saving banks and trust companies under a common management with the commercial banks, all of the lines of safety that have been established through the combined experience of a century of conservative legislation and financial judgment are broken down. The character of service rendered by a life insurance company is one which demands the permanent protection of reserve funds; the trust relations may extend through several generations; protection to these can be secured only through a guarantee of conservative investment. The savings bank has been separated from the commercial bank and other financial institutions for the very purpose of giving to those in control a higher form of conservatism. The character of business that may be handled by a trust company, also, is essentially different from that of a commercial bank. While these various forms of institutions must necessarily supplement each other and co-operate in services rendered to a community, the fiction of a holding company reduces all to a common interest and destroys the element of safety which comes from the

choosing of separate directories and managers for the protection of the several interests involved. The movement simply adds one more element of danger to an already precarious commercial situation.

To summarize current opinion with reference to the elements in "the present financial situation" which should give the American people concern:

After the tide of foreign trade had turned against us and the commercial banks became involved in the stock market to such an extent that they could not purchase gold reserves with which to meet demands for commercial accommodation without forcing the banks to retire from the business of speculative holdings—incidentally perhaps forcing ruinous speculative liquidation—these institutions resorted to the settlement of foreign trade demands as well as arbitrage balances by borrowing on foreign finance bills. The dangers incident to this *first* expedient are found in the fact that it leaves the banks exposed to attack at their weakest point; through demands for gold on these bills, the very foundation of our credit system may suddenly be withdrawn and the superstructure left to fall by its own weight. The possibility of making these demands, also, is left entirely in the hands of foreigners who have no particular interest in maintaining our credit institutions.

Again: the situation growing increasingly tense, the gold balance still going against us, the commercial banks turned to the Treasury. Their need was a need for gold and by obtaining deposits from the government this gold might be transferred from the public vaults to those of private institutions. This process has continued until now banks owe the government about $150,000,000. So long as the Treasury does not need this gold balance to support its outstanding credit currency or to meet current demands for the payment of contracts and running expenses, so long as the importations of foreign goods increase (attracted to our shores by high prices) and the customs revenues are enlarged to abnormal proportions, little harm may come from this form of borrowing. But this is only saying that so long as all goes well we shall have no trouble. When, however, the situation really calls for drastic remedies, when the banks are threatened, and demands are forced home on the purchasers of commercial products, then the decline in government revenues must force its claims upon the list of creditor demands

against the banks, or cause the Treasury to buy gold to protect them. This has in it the possibility of undermining the credit of the banks, or of shaking confidence in the "credit money" issues of the treasury —a repetition of 1893.

The third practice that may be considered cause for deliberation is the new consolidation of financial companies that is being promoted. This may have a reactionary effect even more serious than the other two as it strikes at the very source of the investment powers of the nation. Our investment powers are largely the aggregate of savings of wage earners and persons of small income. These are brought together for capital employment in the savings institutions, in trust companies and in the insurance companies. To reduce or threaten the security of these companies is to cut off the possibility of absorbing new investments offered—to reduce the very powers on which both commercial bank and promoter to-day depend for the final purchase of securities issued. All of the devices referred to are directed toward maintaining a dangerous practice,—one designed for the purpose of allowing the managers of investment institutions to share in the reward of speculation.

The most remarkable feature about current discussion of dangers involved and remedies proposed is this: That while devices are suggested for still further enlarging credit issues of banks, by a system of "assets currency," and by propositions to secure the "deposits of government revenues" as a means of providing a larger reserve for "individual deposits," not a suggestion is made that the banks themselves should strengthen their capital equipment. During the recent autumn and winter strain syndicates were organized to float new combinations involving hundreds of millions of new capital; strong capital support was collected for temporary aid to banks—to strengthen money reserves till the market should become settled; but not an effort is recorded to increase the permanent capital support for credit funds necessary to increased commercial demands. Each proposition made for stronger money reserves for the redemption of credit issues has come from those outside of banking circles. On the other hand, leading bankers are proposing a remedy whereby the capital of commercial banks may be still further reduced—the adoption of a system of "branch banking."

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